

BEFORE THE  
POSTAL REGULATORY COMMISSION

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Periodic Reporting  
(UPS Proposal One)

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: Docket No. RM2020-9  
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UNITED PARCEL SERVICE, INC.'S PROPOSED REPLY  
COMMENTS  
(January 8, 2021)

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United Parcel Service, Inc. ("UPS") respectfully submits these comments in reply to comments submitted by the Postal Service in response to Order No. 5738, Dkt. No. RM2020-9 (Oct. 27, 2020).<sup>1</sup>

**I. THE POSTAL SERVICE'S ARGUMENTS ABOUT INDIVIDUAL MARKET-DOMINANT PRODUCT VOLUMES ARE IRRELEVANT TO THE ECONOMIC CALCULATION OF INCREMENTAL COST**

In response to the UPS Petition, the Postal Service argues that "[c]learly, it is not solely competitive products that cause seasonal peak costs."<sup>2</sup> As support for this assertion, the Postal Service notes that "the volumes of a number of different groups of products experience December increases" and points specifically to the modest (and declining) increase in First Class mail volumes that occurs in December.<sup>3</sup>

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<sup>1</sup> Several other entities submitted comments in this docket, but their arguments largely overlap with those made by the Postal Service.

<sup>2</sup> Initial Comments of the U.S. Postal Service on UPS Proposal One ("Postal Service Comments"), RM2020-9 (Dec. 15, 2020) at 18.

<sup>3</sup> *Id.* at 19.

This argument, however, does not refute the core premise of UPS's Petition: that *all* of the cost increases experienced by the Postal Service every December—the peak season for package deliveries—are incremental costs of competitive products as a group. Neither the Postal Service nor any other commenter meaningfully disputes that conclusion.

39 U.S.C. § 3633(a)(1) mandates that the Commission shall ensure there is no “subsidization of competitive products by market-dominant products.” To satisfy this requirement the Commission has elected to use the incremental cost test for competitive products.<sup>4</sup> Estimating the incremental cost of competitive products as a group requires considering what would happen if the Postal Service stopped delivering packages altogether. As the Commission has recognized, “[i]ncremental costs are the variable and fixed costs that would be eliminated if a product (or products) was (were) (hypothetically) discontinued.”<sup>5</sup>

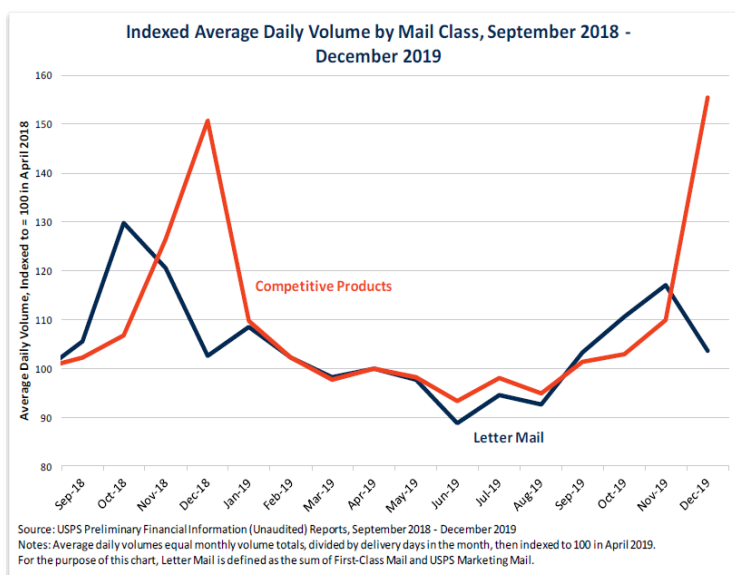
UPS's Petition establishes that, if the Postal Service did not deliver competitive products, its costs would not increase *at all* in December. Instead, they would decrease substantially. This is because, in a world where the Postal Service does not deliver packages, it would have lower *overall* volumes to deliver in December. And this would occur even though First Class mail on its own experiences a modest volume increase in December, because that modest increase is dwarfed by the overall decrease in other market-dominant products.

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<sup>4</sup> Order Establishing Ratemaking Regulations for Market Dominant and Competitive Products (“Order No. 43”), Dkt. No. RM2007-1 (Oct. 29, 2007), at 65.

<sup>5</sup> Order Proposing Regulations to Establish a System of Ratemaking (“Order No. 26”), Dkt. No. RM2007-1 (Aug. 15, 2007), at 65.

A chart UPS presented at the technical conference demonstrates this point, showing that market-dominant volumes significantly decrease overall in December, while competitive product volumes spike during that period:<sup>6</sup>



This data demonstrates that, if the Postal Service did not deliver packages at all, its costs would go down overall in December, rather than increasing sharply. The spike of increased costs that does occur, therefore, must be considered incremental costs of competitive products as a group.<sup>7</sup> No commenter has established otherwise.<sup>8</sup>

<sup>6</sup> Seasonal Increases in U.S. Postal Service Costs Driven by Competitive Products (“UPS Presentation”), Dkt. No. RM2020-9 (filed Sept. 28, 2020), at 4.

<sup>7</sup> In fact, the peak season incremental costs of competitive products extend beyond the cost spike. Conceptually, the entire difference between real-world costs and costs of a Postal Service delivering only market-dominant products is incremental to competitive products. Thus the observed cost spike should be added to the cost savings, relative to the real world, that the Postal Service would realize if it were only delivering market-dominant products in December.

<sup>8</sup> As for UPS’s “pro-rata” solution for attributing this set of incremental costs to individual packages, UPS has acknowledged that this approach is not perfect. But it should be adopted because it is an *improvement* over the current attribution methodology, which is systematically biased by overlooking peak season incremental costs. See 39 U.S.C. § 3652(e)(2).

Contrary to the Postal Service's argument, therefore, the specific volume trends *within* market-dominant products are irrelevant to calculating the incremental costs of competitive products. Because a Postal Service that did not deliver packages would experience *decreased* costs in December, the cost spike that occurs in December is necessarily caused by competitive products. The cost spike is incremental to competitive products and therefore must be added to competitive incremental costs as part of the Commission's analysis under 39 U.S.C. § 3633(a)(1).

## **II. THE POSTAL SERVICE'S DEFENSE OF ITS CURRENT INCREMENTAL COST METHODOLOGY FAILS**

The Postal Service tries to defend the current methodology for calculating the incremental cost of packages, which uses assumptions adopted when package deliveries were a very small part of the Postal Service's business, by arguing that "the volume of competitive products is still quite small."<sup>9</sup>

This defense fails. The current methodology for calculating incremental cost assumes that package deliveries have *no effect* on the structure of the Postal Service's operations. But there can be no real dispute that packages play a very large role in the Postal Service's business operations today. As an enterprise, the Postal Service has stated that its goal is to transform into "a delivery service for the e-commerce era" in which it will deliver "fewer letters and more packages."<sup>10</sup> The Postal Service grew its revenue by \$2 billion in the past fiscal year "due to large growth in package business,"

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<sup>9</sup> Postal Service Comments at 29.

<sup>10</sup> Devin Leonard, *It's Amazon's World. The USPS Just Delivers in It*, Bloomberg Businessweek (July 30, 2015, 7:00 AM), <https://www.bloomberg.com/news/articles/2015-07-30/it-s-amazon-s-world-the-usps-just-delivers-in-it>.

while incurring increased costs by \$2.3 billion because “packages are more expensive to deliver than regular mail.”<sup>11</sup> The Postmaster General recently confirmed that “2020 presented the USPS with an extreme shift as letter mail continued its steep decline and package mail volumes grew rapidly while the COVID-19 pandemic swept the country.”<sup>12</sup>

The Postal Service’s only evidence to the contrary is that competitive products make up “just four to five percent of total volume.”<sup>13</sup> But that metric is misleading. In the newly issued ACR2020 Docket, for example, competitive products account for 42% of the Postal Service’s attributable costs.<sup>14</sup> Other ACR metrics similarly indicate competitive products make up a large proportion of Postal Service business. For example, depending on the quarter, competitive products can account for up to 59% of cubic foot miles on regular Intra-SCF routes and 67% of cubic foot miles on regular Inter-SCF routes.<sup>15</sup> Competitive products also account for 89% of the regular special purpose route (“SPR”) delivery distribution key and 99% of the Sunday SPR delivery distribution key.<sup>16</sup> The discrepancy between the Postal Service’s “four to five percent” figure and those reported in the annual reports is easy to explain—it takes much more work to deliver a package than a letter. Piece counts, like the Postal Service uses in its

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<sup>11</sup> Eric Katz, *Postmaster General Previews New Reforms as USPS Announces \$9B Loss for 2020* (Nov. 13, 2020), <https://www.govexec.com/management/2020/11/postmaster-general-previews-new-reforms-usps-announces-9b-loss-2020/170035/>

<sup>12</sup> Bill McAllister, *PMG DeJoy Calls for ‘New Tone’ for U.S. Postal Service*, Linn’s Stamp News (Jan. 5, 2021), <https://www.linns.com/news/postal-updates/pmg-dejoy-calls-for-new-tone-for-u.s.-postal-service>.

<sup>13</sup> Postal Service Comments at 33.

<sup>14</sup> USPS-FY20-1 FY 2020 Public Cost and Revenue Analysis (PCRA) Report.

<sup>15</sup> USPS-FY20-32 FY 2020 CRA “B” Workpapers (Public Version).

<sup>16</sup> USPS-FY20-32 FY 2020 CRA “B” Workpapers (Public Version).

comments, mask this phenomenon and paint a false picture of the relative importance of market-dominant and competitive products for the Postal Service's business and operations.

The Postal Service is similarly unable to defend its current reliance on a constant elasticity assumption for estimating the incremental costs of packages. The Postal Service does not dispute that the Postal Service's own economist, Professor Bradley, explained that "it is not clear that the [constant elasticity] approximation is accurate at volumes which are very different from the levels at which the underlying functions are evaluated."<sup>17</sup> The Postal Service also does not claim the Commission made an error when the Commission explained the constant elasticity approximation is "unsupported when used for volume levels substantially outside the range of actual experience."<sup>18</sup>

Instead, the Postal Service claims "the presentation of these snippets is misleading."<sup>19</sup> Not so. In the very language the Postal Service cites, the Commission makes clear that the incremental cost model is only reliable "*in a very small range of a component's cost curve where the constant elasticity assumption has been empirically verified* based on observed volumes."<sup>20</sup> All parties agree—the constant elasticity approach should only be used for products (or groups of products) that make up a small sliver of total volume.

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<sup>17</sup> UPS Presentation at 35.

<sup>18</sup> Order Concerning United Parcel Service, Inc.'s Proposed Changes to Postal Service Costing Methodologies (UPS Proposals One, Two, and Three) ("Order No. 3506"), Dkt. No. RM2016-2 (Sept. 9, 2016), at 8.

<sup>19</sup> Postal Service Comments at 30.

<sup>20</sup> *Id.* at 33 (citing Order No. 3506 at 42) (emphasis added).

The Postal Service says “the full quotation by the Commission makes very clear that the constant elasticity is appropriate for the incremental cost model. . . .”<sup>21</sup> This is mistaken. In fact, the Commission explains in the very language the Postal Service cites that “[a]pplying the constant elasticity assumption to levels of volume far beyond the range of actual experience produces results that are inadequately supported and unreliable.”<sup>22</sup> Accordingly, the Commission has determined that the constant elasticity assumption should be used only for small ranges of volume that are within “the range of actual experience.”<sup>23</sup>

Overall, the Postal Service’s assertion that “the volume of competitive products is still quite small”<sup>24</sup> is inaccurate and does not justify the continued reliance on the constant elasticity approach for estimating the incremental costs of competitive products. The Commission should launch economic studies of market-dominant standalone costs as proposed by UPS to provide the foundation for a new approach to calculating competitive incremental costs.

### **III. THE UPS APPROACH FOR COMPUTING THE SEASONALITY SPIKE IS RELIABLE**

The Postal Service claims the “established methodology works in the opposite direction” of the approach in the petition.<sup>25</sup> But the primary difference between the Postal Service approach and the UPS approach is one of order, rather than direction.

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<sup>21</sup> *Id.* at 30.

<sup>22</sup> *Id.* at 30-31.

<sup>23</sup> *See id.*

<sup>24</sup> Postal Service Comments at 29.

<sup>25</sup> *Id.* at 15-16.

UPS starts with the annual estimates of marginal cost per piece, say \$0.10 for a letter, and multiplies by the volume of letters in a month (e.g., if there were 500,000 letters, the costs are \$50,000). UPS repeats the same process for each class of mail. The Postal Service takes annual estimates of variability, say 20%, and multiplies by the amount of total costs in a month (e.g., if there were \$1,000,000 in costs for a cost segment, the Postal Service calculates variable costs of \$200,000 to be distributed to products). Thus UPS could be described as taking a bottom-up approach, beginning with marginal cost, while the Postal Service could be described as taking a top-down approach, beginning with total accrued costs.

While in theory either approach is permissible, there are reasons to doubt the validity of the Postal Service approach. By using *annual* estimates of variability and applying those estimates to *monthly* cost totals, the Postal Service implicitly assumes that variability is the same in each month. That is a significant error, as the data demonstrates that the Postal Service experiences different patterns of cost causation over the course of the year, including during package peak season.<sup>26</sup> During his presentation at the technical conference, Professor Bradley acknowledged that his analysis of the December cost increase assumed that the annual average split between volume variable and institutional cost applied to every month in the year.<sup>27</sup> In the case

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<sup>26</sup> Professor Bradley's Tables 1 and 2, which mirror the analysis he presented in his September presentation, make this assumption. Bradley Report 14-15; see also Michael D. Bradley, *Seasonal Volume Variations and Product Costing*, Dkt. No. RM2020-9 (filed Sept. 28, 2020) at slides 20-22.

<sup>27</sup> While the Postal Service has not produced the calculations cited here, Professor Bradley acknowledged that this is what he had done during the technical conference. See Technical Conference Recording Pt. 2 at 48:49-50:45.



of city carrier, this means the Postal Service's analysis assumes that 48% of city carrier costs are volume variable (and 52% are not) regardless of when these costs are incurred.<sup>28</sup>

*Even if* the Commission was persuaded by the Postal Service's approach, however, the main thesis of the UPS Seasonality Petition remains valid—there is still a large, unexplained spike in costs from November to December of roughly \$250 million. While the Postal Service takes issue with the term “unexplained,”<sup>29</sup> it cannot be disputed that institutional costs are residual costs that are deemed not caused by any product under the Postal Service's cost methodology. The term “unexplained” is thus a fair description of such costs—they are deemed not caused by any products. The Postal Service's Table 5 quantifies the unexplained cost increase at nearly a quarter of a billion dollars.

The Postal Service also claims that, “[i]f a costing methodology is appropriate for December, then it should also be appropriate for other months.”<sup>30</sup> UPS has demonstrated that December, the peak season for package deliveries, differs from other

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<sup>28</sup> Professor Bradley's slide 20 also demonstrates the assumption of a constant variability percentage, as volume variable costs and institutional costs move in parallel in every month. As emphasized by UPS, the Postal Service's use of annual estimates is suspect because these estimates are often measured through special studies and other data collection efforts that occur at idiosyncratic points of the year and are often stale.

<sup>29</sup> Postal Service Comments at 17-18.

<sup>30</sup> *Id.* at 19. In fact, the December-to-January example presented in that discussion is *supportive* of the conclusions presented in Proposal One. Competitive product mail volumes and work content fall from December to January, while market-dominant mail volumes and work content increase from December to January. The fact that unexplained costs are negative when competitive product volumes fall thus reinforces the finding that costs are different in December, and are correlated with competitive product volumes in ways that are not captured by the Postal Service's models.

times of the year in ways that are not captured by the current methodologies. And as all parties acknowledge, December is exceptional in terms of volumes, the composition of those volumes, and costs. Any model that overlooks the unique realities of package peak season will not work as it should and will, instead, be biased against identifying the costs caused by delivering packages. As UPS has demonstrated, that is precisely what is happening under the status quo. It is time for a change.

### **CONCLUSION**

For the reasons discussed above, the Commission should grant the relief requested in UPS's initial comments.

Respectfully submitted,

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